

Monday 20 April

Chair

Cabinet

2009 Budget Package

Proposal

1. This paper seeks approval of the Budget 2009 package.

Executive Summary

2. This Budget is prepared against a very difficult backdrop. The most recent figures for New Zealand's gross domestic product confirmed that the economy was in recession throughout the 2008 calendar year, and forecasts suggest the economy has entered its sixth consecutive quarter of negative growth. Many of our major trading partners are in worse shape with sharper contractions in growth. In the December quarter of 2008 European economies contracted sharply with France down 1.1 per cent, the UK down 1.6 per cent and Germany down 2.1 per cent. The US economy shrank 1.6 per cent in the same quarter, while the falls in Asia were even more noticeable with Japan contracting 3.3 per cent, Singapore down 4.4 and Korea falling 5.1 per cent. Closer to home, Australia's economy contracted 0.5 per cent in the December quarter.
3. Decision making is made even more complicated by the significant uncertainty that underlies all economic forecasts in the current climate.
4. Following the decline in the economic situation, the fiscal position has deteriorated significantly. We are now facing a forecast of significant budget deficits (peaking at \$12 billion in 2012) and mounting debt. Preliminary projections are for gross debt to reach 73 per cent by 2022/23 – even weaker than the projections published in the 2009 Budget Policy Statement in December where debt was projected to reach 57 per cent by 2023.
5. In the 2009 Budget Policy Statement we were clear that we would not let these forecasts eventuate. Budget 2009 is about meeting the commitments we made during the 2008 election campaign, while recognising that economic conditions have changed significantly and we need to respond appropriately.
6. In line with this, the 2009 Budget has three main parts:

- i. Helping New Zealanders through the current crisis;
 - ii. Putting in place longer-term initiatives to lift productivity, improve competitiveness and sharpen New Zealand's future economic performance; and
 - iii. Making the first steps towards fiscal consolidation and implementing changes in policy to ensure that the growth in Government debt is minimised.
7. The emphasis to date has been on softening the immediate impact of the global downturn. The current fiscal impulse – from both baseline spending and new measures we put in place in February - is large and will help sustain the economy for a period.
 8. Based on current economic forecasts, I expect that in Budget 2010 the main issues to be dealt with will be fiscal rather than economic. While preliminary forecasts show a return to growth from quarter four of 2009, the impact on the government's books lasts far longer with deficits persisting beyond 2022/23 and debt continuing to rise.
 9. Taking this into consideration, for Budget 2009 I propose new spending parameters of \$1.45 billion operating per year, and \$1.45 billion capital in total. While on the operating side this is a reduction on the Government's initial plans announced in December, it still represents extra spending of \$7.25 billion over the years 2008/09 to 2012/13.
 10. This amount is net of the significant reprioritisation of existing funding which the savings put forward in this Budget have afforded – total spending is set out below

Table 1: Budget 2009 Spending – including decisions taken by Cabinet prior to Bilaterals

| | \$million increase / (decrease) | | | | | | |
|---------------------------------|---------------------------------|--------------|------------|--------------|--------------|--------------|--------------|
| | Operating | | | | | | Capital |
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | Total | Total |
| New spending | 223 | 1,795 | 1,430 | 1,848 | 1,883 | 7,179 | 1,384 |
| Savings | (173) | (272) | (486) | (562) | (544) | (2,036) | (90) |
| Net increase in spending | 51 | 1,523 | 944 | 1,287 | 1,339 | 5,143 | 1,294 |
| Allowance | - | 1,450 | 1,450 | 1,450 | 1,450 | 5,800 | 1,450 |
| <i>Remaining</i> | <i>(51)</i> | <i>(73)</i> | <i>506</i> | <i>163</i> | <i>111</i> | <i>657</i> | <i>156</i> |

11. Overall spending in this package is high in 2009/10 and relatively low in 2010/11 due to the uneven profile of the small and medium enterprise (SME) tax package – largely due to the deferral of provisional tax. Costs were \$189 million in 2009/10 with savings of \$214 million in 2010/11, aimed at cushioning firms from the effects of the recession in the short term.
12. However, this results in an unusual profile for a between budget contingency. I propose to smooth this within the forecast period as set out in the table below. The final year is not adjusted above the amount remaining – in this case \$111 million – as total spending in the final year is what forms the basis of the ongoing amount available to spend. Were we to increase the size of the contingency in the final year, this would result in total spending in excess of \$1.45 billion on an ongoing basis, with consequent implications for debt and the operating balance.

13. Table 2: Between Budget Spending Contingency

| | \$million | | | | | | |
|-------------------------------------|-----------|---------|---------|---------|---------|-------|---------|
| | Operating | | | | | | Capital |
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | Total | Total |
| Between Budget Spending Contingency | - | 182 | 182 | 182 | 111 | 657 | 156 |

14. This contingency is already under some pressure with a range of proposals being brought to Cabinet today that seek additional funding.

Table 3: Items at Cabinet today that, if approved, will reduce the between Budget contingency

| | \$million | | | | | | |
|--|-----------|--------------|--------------|--------------|-------------|--------------|--------------------|
| | Operating | | | | | | Capital |
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | Total | Total |
| <i>[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]</i> | | | | | | | |
| Redevelopment of National Library <i>Proceeding with the full cost option will not reduce the contingency but will forego the savings of \$43 million available from a storage only option.</i> | - | - | - | - | - | - | - |
| <i>[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]</i> | | | | | | | |
| <i>[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]</i> | | | | | | | |
| <i>Between Budget contingency proposed in this paper</i> | - | 182.0 | 182.0 | 182.0 | 111.0 | 657.0 | 156.0 |
| Remaining to spend | - | 150.7 | 144.8 | 152.3 | 81.3 | 529.1 | 57.0 – 34.5 |

15. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials].*

Background

16. Two factors have complicated the Government's response to the economic situation and the development of this Budget. The first is the rapid deterioration in the world economy following the financial crisis, and the continuing and sharp downward revisions in the forecasts for our trading partners. This has affected both the New Zealand economy and our fiscal position. The most recent GDP figures have confirmed that the economy was in recession throughout the 2008 calendar year and New Zealand is now likely to have entered its sixth consecutive quarter of negative growth (the June quarter of 2009).

17. The second has been the Government's spending path. In the five years from 2005 to 2010 levels of Core Crown expenses grew by almost 50 per cent from \$45 billion in 2005 to a forecast \$66 billion in 2010. When combined with the economic crisis (which has caused Government revenue to fall), this has seen the fiscal position deteriorate significantly. As is set out in the table below, we are now facing a forecast track of significant budget deficits and mounting debt (based on preliminary Treasury forecasts and in the absence of any corrective action).

Table 4: Economic and Fiscal Indicators – Preliminary Economic and Fiscal Forecasts

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|----------------|-----------------|-----------------|-----------------|-----------------|
| Gross Domestic Product (\$m) | 176,244 | 173,639 | 182,281 | 192,069 | 203,749 |
| <i>Change compared to DEFU increase / (decrease)</i> | <i>(4,895)</i> | <i>(10,867)</i> | <i>(11,627)</i> | <i>(13,320)</i> | <i>(12,773)</i> |
| Revenue (\$ million) | 79,546 | 80,668 | 82,808 | 85,359 | 90,663 |
| <i>Change compared to DEFU increase / (decrease)</i> | <i>(1,905)</i> | <i>(871)</i> | <i>(1,638)</i> | <i>(3,008)</i> | <i>(2,899)</i> |
| Operating balance excluding gains and losses (\$ million surplus / (deficit)) | (4,801) | (7,785) | (10,245) | (12,230) | (11,311) |
| <i>Change compared to DEFU increase / (decrease)</i> | <i>(3,989)</i> | <i>(3,758)</i> | <i>(4,342)</i> | <i>(6,055)</i> | <i>(5,136)</i> |
| Gross Debt (% of GDP) | 22.30% | 26.50% | 34.90% | 40.40% | 45.00% |
| <i>Change compared to DEFU increase / (decrease)</i> | <i>3.10%</i> | <i>5.50%</i> | <i>8.90%</i> | <i>11.00%</i> | <i>11.90%</i> |

18. The Budget Policy Statement released in December 2008 set out our intention to meet policy priorities for Budget 2009 within an operating allowance of \$1.75 billion and a capital allowance of \$1.45 billion in total.
19. I also established a process to meet the costs of any emergency pressures that could not be met from baselines through Ministers offering back savings from low value activities within their Votes – through this process more than \$2 billion in savings across the forecast period were realised. In addition some policy commitments of the previous Government which could not be unwound were unfunded and the 2008 Budget contingency was oversubscribed by more than \$200 million in total, so initial policy responses to the recession taken by the government this year have had to count against the 2009 Budget.

Comment

20. Since we came to Government we have had to face the immediate challenges of the unfolding international financial crisis, while at the same time taking longer term actions to create the high growth economy that is our primary objective. Budget 2009 balances these challenges against meeting the commitments we made during the 2008 election campaign.
21. As discussed earlier, the 2009 Budget is in three parts:
- i. Helping New Zealanders through the current crisis;

- ii. Putting in place longer-term initiatives to lift productivity, improve competitiveness and sharpen New Zealand's future economic performance; and
 - iii. Making the first steps towards fiscal consolidation and implementing changes in policy to ensure that the growth in Government debt is minimised.
22. The best policies in this budget deal with two or more of these objectives. For example the SME regulatory and tax reforms measures reduced short-term compliance costs on businesses and will help lift longer term productivity. Increasing the efficiency of public sector agencies can lift productivity in the sector and provide fiscal savings.
23. While the balance sheet is in reasonably good shape right now, the size and structural nature of the deterioration in the Crown accounts means the sooner corrective action is applied the better.
24. In addition, maintaining New Zealand's credit rating means responding to the expectations of credit rating agencies that the Government make definite steps to address the projected rise in debt. Over time it will also be important to reduce the current fiscal stimulus to reduce any pressure on the export sector, and to rebuild the government balance sheet to provide flexibility to face future shocks.

The 2009 Budget Package

25. The key components of each part of the 2009 Budget are set out below.

Helping New Zealanders through the current crisis

26. Health: \$750 million per year which includes funding to meet our pre-election commitments including 12 months' funding for Herceptin; fully funding Plunketline; boosting medical student places; Healthy Housing initiatives and \$25 million per year towards the New Zealand Insulation Fund (see below).
27. Education: \$[deleted – confidentiality of advice] and \$370 million in capital across the forecast period, which includes funding to meet our pre-election commitments of the teachers and principals' collective agreements, the first tranche of the 21st century school building commitment and support for numeracy and literacy standards, as well as increasing the operational funding for schools.
28. New Zealand Insulation Fund: \$244 million across the forecast period, including \$84 million per year in outyears that will help New Zealanders to improve the energy efficiency of their homes, improve Health outcomes, and provide new green jobs to cushion the effects of the recession.
29. Justice: [deleted – confidentiality of advice] and \$214 million in capital across the forecast period to lift prison capacity and fund emergency pressures in the Department of Corrections. In addition, Police will be receiving [deleted – confidentiality of advice] million (out-year cost) in operating and \$25 million in capital across the forecast period to fund additional police as well as emergency pressures in the Police. There are other justice sector initiatives in Courts of [deleted – confidentiality of advice] million in operating and initiatives in Vote Justice of [deleted – confidentiality of advice] million.

Improving Economic Growth

30. The Government's growth strategy encompasses a wide range of measures, with the common theme of raising future living standards of New Zealanders and having the economy emerge stronger than it entered this recession. This is best achieved by lifting productivity and competitiveness throughout the economy. The initiatives fall into two broad areas, those that improve the business environment, and those related to infrastructure.

- Resource Management Act (RMA): \$2 million operating for reform of the RMA and the establishment of an Environmental Protection Agency
- Building Act
- ACC review
- Transport and communications infrastructure, including a \$234 million capital investment in broadband across the forecast period and \$56 million in operating in 2009/10.

Fiscal consolidation

31. Line by line reviews have identified savings that total \$2 billion across the forecast period (see table 1). These savings have helped fund spending in our priority areas and helped limit increases in debt. Further efforts are likely to be necessary as we seek to increase the efficiency of government services and fund future spending priorities.

32. On 6 April Cabinet also agreed to the following changes to fiscal plans so that gross debt to GDP ratios peak at around 45 per cent over the medium term (these changes are not incorporated in the preliminary fiscal forecasts in table 4 above, but will be incorporated into the final forecasts to be published in the final Budget Economic and Fiscal Update).

- to revise the operating allowance to a maximum of \$1.1 billion from 2010/11, growing by the rate of inflation;
- to suspend contributions to the New Zealand Superannuation Fund for the period until the operating balance returns to surplus;
- to make a contribution to the New Zealand Superannuation Fund of \$250 million in 2009/10, with the aim being that this is directed into New Zealand based investments;
- to consider on an annual basis whether to make any further contributions to the New Zealand Superannuation Fund; and
- to delay the second and third tranches of the planned tax cuts in 2010 and 2011.

Moratorium on Papers with Financial Implications

33. Once Budget 2009 has been agreed by Cabinet, there are important production processes that must be completed. In order to ensure that the documentation tabled in the House of Representatives on Budget Day is accurate, Ministers are requested not to submit any papers that have fiscal and/or appropriation implications for agreement by Cabinet between now and 28 May.

Publicity

34. Budget Day is 28 May 2009. The Office of the Minister of Finance coordinates all communications relating to Budget 2009, including requests for early announcements. The Minister of Finance's written approval is required for any early announcements

Consultation

35. This paper was prepared by the Treasury. The Budget package described in the paper was agreed between the Minister of Finance and Vote Ministers through the bilaterals process. This package was confirmed by Budget Ministers in a meeting on Monday 30 March.

Financial Implications

36. This paper proposes a net new spending of \$1.45 billion operating per year and \$1.45 billion capital in total for Budget 2009. While this is a reduction on the Government's initial plans of \$1.75 billion, across the years 2008/09 to 2012/13 it still represents extra spending of \$7.25 billion over and above current baselines.
37. Of the \$1.45 billion operating allowance, a reasonable amount will be held as a between budget contingency to enable the Government to respond rapidly to events as they unfold – both changes in the economic and fiscal situation, and emerging policy priorities such as those initiatives that Cabinet will be considering as a result of the Prime Minister's Summit on Employment.
38. Ministers should only seek funding from the between-budget contingency for urgent issues that cannot be deferred to Budget 2010, and will be expected to demonstrate that they have considered opportunities to fund pressures from existing baselines before seeking funding from the contingency.

Recommendations

The Minister of Finance recommends that Cabinet:

1. **agree** that the 2009 Budget focus on:
 - 1.1 Helping New Zealanders through the current crisis;
 - 1.2 Putting in place longer-term initiatives to lift productivity, improve competitiveness and sharpen New Zealand’s future economic performance; and
 - 1.3 Taking the first steps towards fiscal consolidation and implementing changes in policy to ensure that the growth in Government debt is minimised.
2. **note** the 2009 Budget Policy Statement set an operating allowance of \$1.75 billion operating per year and \$1.45 billion capital in total;
3. **note** the current fiscal impulse is large and will help sustain the economy through the current crisis;
4. **note** economic and fiscal forecasts show a resumption in economic growth but a significant and prolonged impact on the government’s accounts;
5. **agree** new spending parameters of \$1.45 billion operating per year and \$1.45 billion capital in total;
6. **note** the impacts of the 2009 Budget Package as set out in the table below (including the impact of Cabinet decisions already taken)

| | \$million increase / (decrease) | | | | | | |
|---------------------------------|---------------------------------|--------------|------------|--------------|--------------|--------------|--------------|
| | Operating | | | | | | Capital |
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7. **agree** to the initiatives for Budget 2009 as set out in the financial recommendations accompanying this paper;
8. **agree** to delegate authority to the Minister of Finance and the Prime Minister to approve changes to other initiatives where this proves necessary in finalising the 2009 Budget package;

9. **note** that I intend to set aside a reasonable between Budget contingency to enable the Government to respond rapidly to events as they unfold;

| | \$million increase / (decrease) | | | | | | |
|-------------------------------------|--|----------------|----------------|----------------|----------------|--------------|----------------|
| | Operating | | | | | | Capital |
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | Total | Total |
| Between Budget Spending Contingency | - | 182 | 182 | 182 | 111 | 657 | 160 |

10. **agree** that Ministers should only seek funding from the general between-budget contingency for urgent issues that cannot be deferred to Budget 2010, and will be expected to demonstrate that they have considered opportunities to fund pressures from existing baselines before seeking funding from the contingency;
11. **agree** that no papers with fiscal and/or appropriation implications should be submitted for agreement by Cabinet between now and 28 May 2009, to ensure that Budget Day documentation is accurate;
12. **note** that all Budget Day communications are co-ordinated by the Office of the Minister of Finance, and that the Minister of Finance's written approval is required for any early announcements; and
13. **agree** that until the Appropriation (2009/10 Estimates) Bill is enacted, expenses or capital expenditure against appropriations set out in the 2009/10 Estimates and being sought in that Bill may be met from Imprest Supply

Hon Bill English

Minister of Finance